

DOCKET SECTION

BEFORE THE POSTAL RATE COMMISSION

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UNITED STATES POSTAL SERVICE
WASHINGTON, D.C. 20540

POSTAL RATE AND FEE CHANGES, 1997

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DOCKET NO. R97-1

TRIAL BRIEF OF UNITED PARCEL SERVICE

I. INTRODUCTION

United Parcel Service ("UPS") submits this trial brief in order to set forth its positions that:

(1) By not attributing incremental costs, the Postal Service has failed to attribute to Express Mail, Priority Mail, and Parcel Post all of the costs caused by those services;

(2) The Postal Service has not provided a reliable basis for justifying a departure from the Commission's established treatment of mail processing labor costs as 100% volume variable;

(3) The Commission should distribute mail processing costs using the MODS-based approach proposed by the Postal Service;

(4) The Postal Service has failed to follow the Commission's pricing method and its rate proposals thereby depart from the statutory criteria;

(5) The Postal Service has overstated the costs avoided by its proposed Parcel Post worksharing discount categories;

(6) The Postal Service's rate design for Parcel Post is seriously flawed and should be revised; and

(7) It costs substantially more to process Priority Mail parcels than other shapes of Priority Mail, so that a surcharge should be imposed on such parcels.

In addition, the Postal Service's proposal to provide delivery confirmation service at no charge to some Priority Mail users while imposing the costs of that service on all Priority Mail users violates the Postal Reorganization Act.

II. ARGUMENT

A. ALL OF THE COSTS CAUSED BY PROVIDING A CLASS OF MAIL MUST BE INCLUDED IN THE ATTRIBUTABLE COST FLOOR TO WHICH A REASONABLE PORTION OF UNATTRIBUTED COSTS MUST BE ADDED.

Congress' overriding intent in enacting the Postal Reorganization Act and establishing the Commission as an independent ratemaking body was to thwart the inevitable temptation for the Postal Service to exploit the monopoly over letter mail by imposing the lion's share of postal costs on First Class Mail. See S. Rep. No. 912, 91st Cong., 2d Sess. 13 (1970). The Commission has echoed Congress' concern by recognizing the need for "postal ratemaking . . . to assure that every piece of mail pays rates sufficient to compensate the Postal Service for whatever costs the service incurs in order to provide that service." Postal Rate & Fee Changes, 1990, Docket No. R90-1, Opinion and Recommended Decision at IV-3 ("R90-1 Opinion").

To that end, Section 3622(b)(3) of the Act requires that all “direct and indirect postal costs attributable” to a class or type of mail be included in the rate floor for that class or type. Unlike the other Section 3622(b) factors, Section 3622(b)(3) is a requirement, not a discretionary consideration; it is “the only immutable pricing requirement of the Act,” and it must be considered independent from and prior to applying the other Section 3622(b) criteria. Postal Rate & Fee Changes, 1983, Docket No. R84-1, Opinion and Recommended Decision at 259 (“R84-1 Opinion”). See also Postal Rate & Fee Changes, 1994, Docket No. R94-1, Opinion and Recommended Decision at IV-17 (“R94-1 Opinion”) (“The first imperative of rate-making under the Postal Reorganization Act is the recovery of attributable costs in rates”).

The Supreme Court has held that “causation is both the statutory and the logical basis for attribution.” National Association of Greeting Card Publishers v. United States Postal Service, 463 U.S. 810, 820 (1983) (“NAGCP-IV”), citing Postal Rate & Fee Changes, 1974, Docket No. R74-1, Opinion and Recommended Decision at 110 (“R74-1 Opinion”). Moreover, the Court provided a broad interpretation of what it means for a cost to be caused by a class of mail. Indeed, the Court held that the Act “requires that all costs reliably identifiable with a given class, by whatever method, be attributed to that class.” Id. (emphasis added). As the Court held, “Congress’ broad policy was to mandate a rate floor consisting of all costs that could be identified, in the view of the expert Rate Commission, as causally linked to a class of postal service.” Id. at 833 (emphasis added).

The Commission has always implemented Section 3622(b)(3) by first determining the costs caused by each subclass of mail and then applying a markup on top of the attributed costs of the class to reflect the appropriate contribution of the class to institutional costs in light of the factors set forth in the Act. Historically, the Commission has based its cost causation determinations on findings of volume

variability supplemented by instances where certain fixed costs are incurred solely to provide one subclass of mail. In this proceeding, the Postal Service has greatly advanced the process of determining cost causation by estimating the incremental costs of each subclass. However, the Postal Service proposes to negate this advance by departing from the Commission's established practice -- a practice required by Section 3622(b)(3) -- of marking up the costs caused by each class; it instead proposes to mark up only a portion of attributable costs, i.e., the volume variable costs of the various subclasses.

The Postal Service's approach not only is a significant departure from Commission practice, it is also contrary to the statute. Moreover, it is not good policy, for the reasons explained by UPS witness Henderson. See UPS-T-3 at 9-12.

The Commission has already explicitly rejected the notion that attributable costs are limited to short run volume variable costs. In particular, the Commission has held that long run incremental costs should be included in the attributable costs of a class because "whenever a reliable causal relationship appears between a class of mail and a defined cost function, that function becomes a candidate for attribution, or . . . inclusion as part of the incremental cost of the class." Postal Rate and Fee Changes, 1987, Opinion and Recommended Decision ("R87-1 Opinion") at 102. Specifically, the Commission has held that "[t]he relation between incremental cost and the class it is associated with thus appears to be the same relation as 'attributability' under the Act." Id. at 101. See also id. at 106 (One of the "reasons for choosing 'long-run variable costs' as the floor for rates . . . relies on fairness.") (citation omitted).

As Dr. Henderson has testified and as the Postal Service's own witnesses have acknowledged, USPS-T-11 at 8-9 (Postal Service witness Panzar) and USPS-T-41 at 3 (Postal Service witness Takis), the incremental costs presented by Postal Service witness Takis are caused by providing service to the various subclass of mail.

Accordingly, those costs are attributable and form the cost floor to which a portion of unattributed costs must then be added.

**B. THE COMMISSION SHOULD ADHERE TO ITS
LONG-HELD TREATMENT OF MAIL PROCESSING
LABOR COSTS AS 100 PERCENT VOLUME VARIABLE.**

In previous postal rate proceedings, the Commission has, with minor exceptions, attributed essentially 100% of mail processing labor costs. In this proceeding, however, the Postal Service takes the position that mail processing labor costs do not vary fully with changes in mail volume. The study presented by the Postal Service in support of this position contains a number of flaws that render it unreliable. Because the Postal Service has failed to provide a credible justification to diverge from the Commission's traditional treatment of mail processing labor costs, those costs should continue to be fully attributed.

1. The Postal Service's Study

In its effort to persuade the Commission to depart from precedent, the Postal Service has offered the testimony of Michael D. Bradley (USPS-T-14). Dr. Bradley's testimony presents an econometric estimation of a series of cost equations relating the number of labor hours in specific activities, facilities, and accounting periods to the number of times pieces of mail are handled in those activities, facilities, and accounting periods. However, as discussed in detail in UPS witness Neels' testimony (UPS-T-1), Dr. Bradley's analysis is flawed: it does not use data on costs; it uses unreliable measures of Dr. Bradley's "piece handlings" proxy for volume; and it is the result of subjective and unverifiable judgments which result in ignoring substantial data.

(a) Dr. Bradley's Study Uses Inappropriate Proxies For Costs And For Volume.

Instead of focusing on actual labor costs, Dr. Bradley relies upon labor hours spent on the various activities he examines as a proxy for volume. As Dr. Neels shows, while labor hours and costs are related, they are not direct proxies for one another. By using labor hours as a proxy for labor costs, Dr. Bradley fails to account for a number of factors that affect the relationship between costs and volume.

For example, if increased volume causes the labor mix to shift toward overtime, then the volume increase will lead to a greater increase in labor costs than in total labor hours. As a result, the increase in hours will not capture the full impact of the increased volume on costs. For this and other reasons given by Dr. Neels, hours are not a reliable proxy for costs, and Dr. Bradley's reliance on hours undercuts the validity of his study.

Dr. Bradley likewise fails to use a suitable proxy for volume. He bases his conclusions on an analysis of "total piece handlings," which is a measure that is distinctly different from volume. Dr. Neels explains that using piece handlings as a proxy for volume could easily lead to erroneous conclusions on the volume variability of costs.

(b) Dr. Bradley's Study Uses Unreliable Data.

Dr. Bradley's study is also flawed because his piece handling data has been severely questioned and criticized by the Postal Service's own Inspection Service. In a recent review conducted by the Inspection Service, large variances attributable to various causes were found between the piece handling figures contained

in the MODS system used by Dr. Bradley and actual piece counts.¹ Dr. Bradley's testimony is premised on that data, and the deficiencies in the MODS piece handling data directly and significantly affect the reliability of his analysis.

**(c) Dr. Bradley's Study Ignores Much
of the Relevant Data.**

Dr. Bradley's volume variability estimates are based on data that is the end product of an unusual and aggressive approach whereby he eliminated from his analysis substantial amounts of data based solely on unverifiable subjective judgments. As recognized by the Commission, data editing and the deletion of outliers are susceptible to manipulation. See R90-1 Opinion at III-76. Dr. Bradley's data "scrubs" are especially suspect because the volume variability estimates he derives from his "scrubbed" data differ drastically from the results obtained when all of the data are used.

In all, Dr. Bradley discarded over 50,000 observations from the data. In 21 of the 23 activities he considers, he discarded over ten percent of the data. In seven instances, he discarded over 20 percent of the data. In two cases he discarded over 30 percent of the data, and in one case he discarded a startling 49 percent -- almost half -- of the usable data. Such extensive "editing" of the data raises serious questions concerning the representativeness of Dr. Bradley's conclusions.

¹ National Coordination Audit: Mail Volume Measurement and Reporting Systems, United States Postal Inspection Service, December 1996, USPS library reference H-220, at 8.

2. The Bradley Study Fails To Measure Long-Run Variability.

Just as important, Dr. Bradley's analysis fails to shed light on the long run volume variability of costs. His analysis is essentially a short run analysis rather than a long run analysis of the type the Commission has held to be relevant for ratesetting purposes.

For these reasons and others given in Dr. Neels' testimony, Dr. Bradley's study does not justify a departure from the Commission's well-established and consistently applied precedent that mail processing labor costs are essentially 100 percent volume variable. Because of the serious shortcomings in Dr. Bradley's study, the Commission should reject it and reaffirm its traditional treatment of the attribution of mail processing labor costs.

C. THE COMMISSION SHOULD ADOPT A MODS BASED ALLOCATION OF MAIL PROCESSING COSTS.

Postal Service witness Degen (USPS-T-12) has developed an approach to distributing mail processing labor costs to the various subclasses of mail that represents a substantial improvement over the current approach. As explained by UPS witness Sellick (UPS-T-2), Mr. Degen's method is an improvement over prior practice because (1) it links the distribution of mixed mail and "overhead" (not handling mail) costs with the operational characteristics of mail processing, and (2) it makes use of all available information on the contents of items and containers.

The result is a significant refinement of the mixed mail distribution methodology. Mr. Degen's new cost pools more closely correspond to operational characteristics and machine type, which directly affect the costs incurred in processing mail, rather than being based on CAG and Basic Function, categories which do not

drive mail processing labor costs. Thus, under the new approach, there is a much more accurate analysis using factors that are more closely related to mail processing costs.

The Postal Service's refinement allocates the costs of not handling mail for various mail processing operations (e.g., moving empty equipment) to those subclasses of mail that are found on the same machine type or in the same processing operation when those employees are handling mail in each operation. For example, the cost of postal employees found not handling mail while in the manual Priority Mail processing operation are allocated to the subclasses of mail which those employees work on when they are handling mail.

While the new approach proposed by Mr. Degen may not be perfect -- no cost distribution method is ever perfect -- under it mixed mail distributions reflect actual data on the contents of the same types of items and containers. This is certainly an improvement over the previous practice of allocating the costs of containers with mixed shapes of mail in proportion to the set of all direct mail tallies, which ignores the fact that different types of containers are more often used for different types and subclasses of mail. Under Mr. Degen's approach, the undeniable relationship between item types and certain classes or shapes of mail is recognized by distributing the costs of uncounted items in proportion to the direct mail in those same item types.²

Because the actual cost distributions presented by Mr. Degen are based on Dr. Bradley's unsupported argument that mail processing labor costs are not 100 percent variable, minor modifications must be made to Mr. Degen's distributions in

² Since Mr. Degen does not rely on the MODS piece handling data used by Dr. Bradley but rather relies only on MODS workhours data, his approach does not suffer from the same flaws -- and is not subject to the same criticisms -- as is Dr. Bradley's variability analysis.

order to make it consistent with the Commission's approach of attributing 100 percent of mail processing labor costs. As explained by Mr. Sellick, the Commission has found that in certain limited instances, some mail processing labor costs are fixed and not attributable. Those determinations must be taken into account. Also, certain costs previously classified as administrative and assigned to Cost Segment 3.3 are included in Cost Segment 3.1; those costs should be reclassified to ensure treatment consistent with the Commission's established practice. Making these modifications preserves the essential improvements under Mr. Degen's approach while maintaining the integrity of the Commission's prior costing determinations.

D. THE ASSIGNMENT OF ALL OTHER, UNATTRIBUTED COSTS SHOULD REFLECT THE RATE RELATIONSHIPS PREVIOUSLY ADOPTED BY THE COMMISSION.

As discussed in UPS witness Henderson's testimony, the Commission's rate recommendations must insure that the rate for each class of mail includes all costs attributable to the class "plus that portion of all other [unattributed] costs of the Postal Service reasonably assignable to such class or type." 39 U.S.C. § 3622(b)(3) (emphasis added).

The reasonable assignment of those costs that cannot be attributed is governed by the non-cost factors in Section 3622(b) and the other policies of the Act. In prior cases, the Commission, in assigning unattributed costs, has evaluated each class or type of mail in light of all of the statutory pricing policies in § 3622(b). In so doing, the Commission

has ameliorated potential uncertainty about the effects of each of the policy guidelines by adhering to a consistent, evolutionary application of these standards over the 20-year history of quasi-judicial ratemaking.

R94-1 Opinion at IV-2. In short, the Section 3622(b) non-cost considerations have been incorporated into the Commission's deliberative process in establishing the institutional cost markups in prior rate cases, and those prior determinations should not be disturbed unless a demonstrable change in circumstances warrants some departure from them. As the Commission itself has stated, the previously established markups are "presumptively reasonable." R87-1 Opinion at 367.

Neither the Postal Service nor UPS witness Henderson has found any circumstances which warrant a major departure from the Commission's prior findings with respect to Express Mail, Priority Mail, and Parcel Post. Thus, Dr. Henderson presents average subclass rates for those classes that are based on the Commission's relative markup framework from Docket No. R94-1.

With respect to Express Mail, applying the Commission's prior approach results in an average rate of \$13.51, with a cost coverage of 118.1 percent. This requires a rate increase of 4.4%. For Priority Mail, the Commission's established evaluation of the non-cost factors leads to an average rate of \$4.66 and a cost coverage of 193.1 percent. That requires a rate increase of 32%, which is largely dictated by a 31% increase in Priority Mail's attributable costs. Finally, for Parcel Post, a 28% rate increase is required to comply with the statute. Much of that increase -- more than 19% -- is required by the fact that Parcel Post rates are already substantially below cost.³

³ As testified to by Mr. Luciani and Postal Service witness Mayes, Alaska air costs are incurred to handle Parcel Post mail, meet the definition of attributable costs, and therefore should be attributed to Parcel Post.

**E. THE POSTAL SERVICE'S PROPOSED PARCEL POST
WORKSHARING DISCOUNTS ARE BASED ON INFLATED
ESTIMATES OF AVOIDED COSTS AND ITS RATE
DESIGN IS DEFECTIVE.**

1. DBMC Entry

The Postal Service's proposed DBMC discount is dramatically higher than that previously approved by the Commission. UPS witness Luciani demonstrates that this results from a severe overstatement of the pool of costs that DBMC entry avoids.

Contrary to prior Commission practice, the Postal Service has included mail preparation costs in the costs avoided by DBMC entry and has double counted the window and acceptance costs avoided by DBMC by including them in its calculations of both the platform acceptance and mail processing costs avoided by DBMC mail. The Postal Service has also failed to exclude any ASF costs from the pool of outgoing mail processing costs avoided by DBMC entry despite the fact that when an ASF acts as a BMC, the outgoing mail costs that are incurred by DBMC parcels at BMCs are also incurred by DBMC parcels at ASFs when those facilities operate as a BMC.

Adjusting for each of these overestimations, Mr. Luciani computes a revised non-transportation avoided cost for DBMC entry of 36.6 cents per piece.

2. OBMC Entry

The OBMC entry avoided cost (which is deducted from the inter-BMC rates) is calculated as the sum of the DBMC entry non-transportation avoided cost plus additional costs saved at the OBMC itself (due to the presorting requirement for the OBMC discount). Thus, the cents per piece decrease in avoided costs for DBMC entry also reduces the avoided costs for OBMC entry by the same amount. Therefore, Mr. Luciani calculates a revised OBMC entry avoided cost of 47.3 cents per piece.

3. DSCF Entry

Rather than relying on actual data used by Postal Service witness Daniel, Postal Service witness Crum assumes that the average number of DSCF parcels per container is 10 machinable parcels per sack and 25 non-machinable parcels. His analysis is also based on the premise that, contrary to Postal Service practice, DSCF entry shippers will unload their dropshipped parcels without Postal Service assistance. Mr. Luciani demonstrates that these assumptions -- and accordingly, the proposed discount based upon them -- are wrong.

Ms. Daniel's actual data establishes that there are, on average, 5.8 machinable parcels per sack and 17.4 non-machinable DSCF pieces per GPMC. Using any other figures is speculative. Similarly, the Postal Service's own DSCF dropshipment procedures explicitly state that Postal Service employees unload dropshipped containers at the DSCF and assist in unloading dropshipped bedloaded mail. Correcting Mr. Crum's erroneous assumptions decreases the DSCF entry non-transportation avoided costs by 6.7 cents.

Mr. Luciani also adjusts the transportation cost avoided by DSCF entry by 12.3% to account for Mr. Hatfield's underestimation of the actual cost incurred by parcels that travel on the DSCF to DDU leg. This 12.3% adjustment yields a revised total DSCF transportation cost of \$0.4465 per cubic foot.

4. DDU Entry

In deriving the non-transportation cost avoided by DDU entry, Mr. Crum once again makes an unsupported assumption that is unreliable. He assumes that mailers will shake out the DDU entry sacks after unloading them. It is more probable that mailers will leave sacks for the Postal Service to shake out after they unload the

sacks on the platform. Accordingly, Mr. Luciani reduces the proposed DDU discount by 1.1 cents per piece.

5. Prebarcoding

The Postal Service's proposed prebarcoding discount is also inflated. There is no evidence to support Ms. Daniel's assumption that prebarcoding will avoid substantial non-modeled costs that have a proportional relationship to the cost of scanning in comparison to keying. Ms. Daniel's 62% adjustment factor is inappropriate when deriving cost savings for only one avoided operation. Any prebarcoding cost savings should be limited to the difference between the cost of a key punch and the cost of a scan, or approximately 2¢ per piece.⁴

6. The Postal Service's Excessively High Passthroughs Should Be Rejected.

The high passthroughs of estimated avoided costs proposed by the Postal Service -- 98% to 100% -- should be rejected. Such a high level of passthroughs is contrary to the Commission's prior practice for new Parcel Post worksharing activities.

There is simply too much uncertainty about the amount of costs that will actually be avoided by these worksharing proposals to support 100% passthroughs. It is particularly precarious for the Commission to approve high passthroughs for discounts when the cost savings are for new discounts which are as yet unproven. To approve full passthroughs within a subclass with a cost coverage as low as that for Parcel Post jeopardizes the ability of the class as a whole to cover its attributable costs.

⁴ The only support for increasing the discount by 0.5¢ per piece for saved "ribbon costs" consists of two words: "Engineering estimate."

As Mr. Luciani's testimony shows, numerous factors demonstrate that the proposed cost savings are uncertain. In addition, because the proposed new discounts would result in more lost revenue than the additional cost savings, the Postal Service will have to recoup this loss from Parcel Post as a whole -- specifically, from single piece and small volume mailers. Thus, the proposed discounts -- based on uncertain cost savings -- would result in higher rate increases for non-workshared categories. Therefore, the Commission should follow its established practice and apply a uniform 77% passthrough rate.

UPS witness Luciani proposes other revisions to the Postal Service's derivation of Parcel Post rates. These are detailed by Mr. Luciani at pages 31-41 of his testimony. One of the more significant revisions he proposes is to treat intra-BMC intermediate transportation costs as partially distance-related. Not only is this more in accord with the reality of transportation cost incurrence, but it also helps ameliorate rate crossover issues within Parcel Post. The Commission should adopt the changes recommended by Mr. Luciani in designing appropriate Parcel Post rates.

F. THE COMMISSION SHOULD IMPOSE A SURCHARGE ON PRIORITY MAIL PARCELS TO RECOGNIZE THE HIGHER COST OF HANDLING SUCH PARCELS.

In light of the Commission's finding in Docket No. MC95-1 that it costs the Postal Service more to process Standard (A) parcels than Standard (A) letters and flats, UPS witnesses Sellick and Luciani investigated and determined that there are also significant processing cost differences between Priority Mail parcels and flats. As shown in Mr. Sellick's testimony, Priority Mail parcels cost significantly more to process than do Priority Mail flats. Thus, Mr. Luciani recommends that the Commission adopt a surcharge of ten cents per piece for Priority Mail parcels. As discussed by Mr. Luciani, this surcharge is reasonable (reflecting the 19.5 cent cost difference found by Mr.

Sellick minus the 9.3 cents of non-transportation weight related costs for Priority Mail parcels) and would mitigate the crossover problem between Parcel Post rates and Priority Mail rates.

**G. LARGE PRIORITY MAIL USERS SHOULD NOT GET A
FREE RIDE FOR DELIVERY CONFIRMATION SERVICE
AT THE EXPENSE OF OTHER MAILERS.**

All of the cost of Priority Mail electronic delivery confirmation service, designed for large volume users, is included in the base cost of Priority Mail as a whole. However, as noted by Mr. Luciani, fairness requires that the cost of delivery confirmation be borne solely by those who will use it, and that those who do not use this special service should not have to pay for the costs incurred in providing it to others.

To correct this unfairness, Mr. Luciani recommends that the Commission impose a per transaction fee of 25 cents for electronic Priority Mail delivery confirmation -- the same fee the Postal Service proposes for electronic Standard (B) delivery confirmation (which has the same cost) -- and a transaction fee of 60 cents for manual delivery confirmation, which again is the same fee (with the same costs) as Standard (B) manual delivery confirmation.

III. CONCLUSION

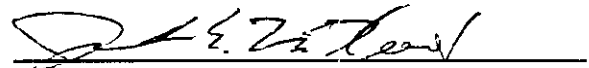
For the reasons set forth above and on the basis of the evidence in the record, the Commission should:

1. Attribute to each class of mail the incremental costs of the class, so that the rate floor contains all costs caused by the class;

2. Follow its well-established determination that mail processing labor costs are 100 percent volume variable;
3. Adopt a MODS-based allocation of mail processing costs;
4. Assign unattributed costs on the basis of the relative markups adopted in Docket No. R94-1;
5. Correct the Postal Service's overstatements of avoided costs in the proposed Parcel Post worksharing documents;
6. Incorporate the Parcel Post rate design revisions set forth in Mr. Luciani's testimony; and

7. Implement a surcharge of 10 cents per piece for Priority mail parcels and require Priority Mail users who opt to use the proposed delivery confirmation service to pay the costs of rendering that service.

Respectfully submitted,



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**CERTIFICATE OF SERVICE FOR TRIAL BRIEF
OF UNITED PARCEL SERVICE**

(February 10, 1998)

The undersigned, counsel for United Parcel Service, hereby certifies that the Trial Brief of United Parcel Service was served on all parties to this proceeding in accordance with section 12 of the Commission's Rules of Practice this 10th day of February, 1998.

Respectfully submitted,



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